

COMMONWEALTH OF MASSACHUSETTS
Massachusetts Department of Revenue
Audit Division
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Encrypted Cigarette Stamps

With the expiration of its Cigarette Stamp Contract in 2008, Massachusetts decided to be in the forefront of cigarette stamped product and the protection of its tax base. With large seizures of counterfeit stamp product in New York, Michigan and California, Massachusetts determined that it was only a matter of time before large scale entry of counterfeiting crossed its borders and it was the appropriate time to invest in a system designed to slow if not eliminate the problem.

In most instances Counterfeiters target high tax states. Currently Massachusetts with an Excise Tax rate of \$2.51 per pack ranks seventh in the nation. With the current rate, annual tax collections exceeded over \$ 562 million dollars during Fiscal Year 2009 ending on June 30th, 2009. Massachusetts believes the transition to the encryption process will protect these receivables with the possibility of increasing the excise collected.

In 1997 the State of New York seized 96,000 counterfeit cigarette stamps; in October 2005 California 103,000 counterfeit CA stamps along with over 200,000 stamps from Arizona, Texas and Nevada. Finally in December 2005, Michigan seized over 23,000 counterfeit Michigan stamps. Massachusetts did not wish to be the next targeted state for illegal stamps.

During Fiscal Year 2009 Massachusetts uncovered its first counterfeit problem. Four cigarette seizures took place with over seventeen hundred packs of counterfeit stamped cigarettes seized. These seizures occurred during one of DOR's established Drives that are performed each year. What DOR found troubling was that the seizures occurred in three different parts of the state. With seventeen hundred uncovered, in all likelihood there were many more. We now knew we had a problem but we are still not certain just how severe.

These Cigarette Drive(s) have been performed for the past fifteen years and usually resulted in unstamped product or lower tax states product that was purchased and brought into the Commonwealth. DOR Drives are usually five days in duration visiting approximately one thousand Retailers. We conduct these Drives regularly each year and have seized or confiscated over 100,000 packs of illegally stamped product most of which were either unstamped or stamped by another state. However, in 2009 we located for the first time these counterfeit stamped cigarettes.

Cigarette Drives are also used to verify appropriate licenses and tax registrations. DOR personnel are also prepared to provide outreach to the taxpayers to give first hand service with problems and questions taxpayers may have. Personnel equipped with Tablet Laptops are also available to update information on taxpayer profiles and other data. This type of face to face communication is invaluable when documenting taxpayer activity.

One aspect in which DOR felt we were behind in was the authentication process of the stamps. In prior years where each state stamp was similar in size, the stamp color of the Massachusetts stamp was the first line of defense. However, when a neighboring state changed colors, we needed to change colors as well depending on their selection.

The authentication process was the utilization of a “*Laser Pen Light*” which often times did not work properly due to lighting. DOR personnel were required to take several packs to an area of the store with limited lighting to verify the authenticity of the stamp. This prevented us from verifying all packs and was not always reliable. The new process will allow us to review all packs for authenticity of the stamps and in most cases without removing them from the racks.

The overt features within the new stamp will provide the purchaser with multiple ways to determine whether the stamp is authentic with the naked eye. The vendor, SICPA Product Security LLC has partnered with Meyercord Revenue to create features such as the 6 digit alphanumeric identifier unique to each stamp, a red to green ink color shift and micro text printing. In addition, there are several covert features implanted into the stamp that can only be read by a security device issued to DOR personnel.

The new process will also involve hi-tech scanners used by DOR personnel that will be keyed with Retailer information prior to entry into the location. Personnel will then have the ability to authenticate the entire cigarette inventory in half the amount of time currently allotted. We will also have the ability to validate certain packs as to the name of the Wholesaler/Stamper and when the packs were stamped. This will give us added audit information for future reference.

Scanner data will then be downloaded within a database and will be utilized for shipment verification as well as Retailer and Stamper audit selection.

Inexpensive Validators will be available for sale on our web-site for Retailers to purchase. These Validators will enable Retailers and consumers to quickly determine the authenticity of the stamps. DOR considers this a first line of defense in its encryption program.

Master Settlement Agreement:

Since 1999 Massachusetts has received over three billion dollars from the agreement between states and the Tobacco Industry. This agreement known as the Master Settlement Agreement (MSA) on average has provided Massachusetts annually over \$250,000,000 million to be used in providing needed funds for healthcare. This agreement requires Massachusetts to ensure only product approved for sale in the Commonwealth is stamped and sold. Specifically, DOR must diligently enforce the sale of approved product made by Non-participating Manufacturers pursuant to Massachusetts Model Statute, M.G.L. c 94E.

Massachusetts wants to ensure the flow of funds generated by this agreement continues to fund the health related costs from tobacco. The Participating Manufacturers are questioning whether the states have met their obligations to enforce the sale of product made by Non-participating Manufacturer's product. Although we in Massachusetts through our Drives and other audit means feel that we have met this obligation, the new Encryption System will ensure continued due diligence on our part.

With this new technology, all stamping equipment at Wholesaler/ Stamping locations will only allow approved product to be stamped. Approved product is product listed on the Massachusetts Tobacco Product Manufacturer Directory, which DOR maintains on its web-site pursuant to M.G.L. c 94F. This will be accomplished through a computer system maintained by DOR using a list of cigarette brand UPC Codes and product descriptions. DOR will continuously monitor and maintain this list which will ensure only approved product is stamped 24/7. If the brand information is not on our list, the stamping equipment will not allow the product to be stamped.

The Commonwealth of Massachusetts will be the first state to ensure only MSA approved product can be stamped by its Wholesaler/Stamper licensees.

Fire Safe Cigarettes:

Effective January 1, 2008 and pursuant to M.G.L. c 64C, sec. 2E, all cigarettes sold in Massachusetts were required to be “fire safe”. Fire safe requires cigarette manufacturer certification and tests results indicating that a cigarette “shall not exhibit full-length burns” when left unattended. Through the use of product brand approval similarly with the MSA agreement, Massachusetts will be able to monitor brands sold and working with our Department of Public Safety branch ensure only approved product will be stamped. This should ultimately lead to compliance of this law and ensure safety of our citizens.

Closing:

No one is exactly sure how much product sold in Massachusetts or any state is counterfeit whether it is the stamps or cigarette product sold. Examples from various reports have indicated a high volume counterfeit or inter-state trafficking of tobacco product across the country. Federal officials have tracked and identified illegal product sold by individuals with profits filtered to the Middle East and used for terrorism. There is no one in this organization that has the ability to gauge just how much of this occurs within Massachusetts.

However, we feel that with the Encryption Process we have taken the correct steps that will limit the counterfeiting may be going on in our state. We also believe that by reducing counterfeiting, we will be protecting our Excise and Sales Tax base, continue our diligent enforcement of our M.G.L. c 94E required by the Master Settlement Agreement and strengthen our ability to monitor Fire Safe Product sold in Massachusetts.

References:

- 12/3/2008 *The Mackinac Center for Public Policy estimated a loss of 13.8% of cigarette sales due in Massachusetts to the sale of commercial smuggling from import states.*
- 8/27/2009 Fiscal Economics Inc. estimates that 63 million packs or 21.9% of cigarettes consumed in Massachusetts were illegally imported into Massachusetts.